MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

Washington Monthly Report

Three weeks into the new fiscal year, Congress continues to struggle to enact the 13 appropriations measures that are necessary to keep the Federal government operating. Five of the 13 appropriations measures have been signed into law by the President, another has been vetoed, and three more have been passed by Congress and are on their way to the President. Three more have been passed by both Houses and are at the stage of a House-Senate Conference to resolve differences between the competing versions. The remaining appropriations measure -- funding the Departments of Labor, Health and Human Services, and Education -- is both the largest and the most difficult to enact without breaching the budget caps. Meanwhile, the "continuing resolution" providing temporary funding to keep the Federal government operating until the necessary appropriations legislation is enacted is scheduled to expire shortly.

The Congressional GOP leadership has vowed to avoid a repeat of last year's wild end to the Congressional session in which most of the Federal government's funding was folded into a single omnibus appropriations measure negotiated by Congressional leaders and the President's Chief of Staff. The President has threatened to veto a number of the remaining appropriations measures, and the Congressional GOP leadership has indicated that it will try to negotiate each appropriations measure individually. However, with time running out and both the President and the Congressional GOP leadership publicly committed to not spending any of the Federal budget surplus attributable to Social Security revenues, such an omnibus negotiation between Congress and the Administration seems almost inevitable.

While a very slim possibility remains of a "global" budget summit between the Administration and Congressional leaders tying together spending, Medicare, Social Security, and tax cuts, just getting the necessary appropriations measures enacted to continue funding the ongoing operations of the Federal government is likely to prove controversial enough, without adding the political landmines of broadscale Medicare changes and Social Security reform to the mix. At this juncture, the most likely scenario appears to be that Congress will just try to enact the necessary appropriations measures and then get out of town.

Elk Hills Compensation

Each year the task of securing the Elk Hills money for California and its teachers has given rise to some new wrinkle and new daunting challenge. First, it was a matter of getting the Federal Government to sell off Elk Hills in the first instance, in order to create a pot of sale proceeds against which the State could assert its claim for compensation. Then, once the decision had been made to privatize Elk Hills, the State had to force its way into the authorizing legislation for the sale, to give recognition to the State's claim and to establish a process for resolution of the claim. Once the legislation directing the sale had been enacted, the focus turned to forcing the Administration to follow the process that Congress had laid out for settling California's claim. After year-long negotiations finally produced a $320 million settlement for California and its teachers, the task then became securing the Congressional appropriation to fund the Federal government's obligation to pay compensation in annual installments under the settlement agreement.

Last year, we were still dealing with the aftermath on Capitol Hill of the settlement itself, with a substantial quarter of the Congress still fighting the last war by asserting that the State's claim had no validity. This controversy helped keep the necessary Elk Hills appropriation out of both the House and Senate Interior Appropriations measures. A high-profile exercise involving the President's Chief of Staff and the Speaker of the House acting at the behest of Rep. Bill Thomas was required to shove the $36 million Elk Hills appropriation into the final omnibus appropriation legislation for FY 1999.

This year, it was supposed to be easier. Last year’s high-profile shoving of Elk Hills into the final appropriations legislation when it had been in neither the House nor the Senate measures made a real impression on Capitol Hill and surmounted an important threshold of credibility for this year’s effort and beyond. The past Congressional carping over the validity of the State's claim has largely faded away. Earlier this year we obtained a strong letter of support for Elk Hills funding signed by the entire 52 Member California Congressional delegation. As the result of these efforts, the necessary $36 million appropriation for the next annual installment of Elk Hills funding was included in the Interior Appropriations reported out by the House Interior Appropriations Subcommittee – traditionally the strongest opponent of Elk Hills compensation – and was approved by the full House of Representatives. Senator Feinstein, a Member of the Senate Interior Appropriations Subcommittee, has been an active supporter of Elk Hills funding.

However, a surreal air has descended upon Washington. At a time of unparalleled surpluses, the Federal budget has found itself in the strait-jacket of rigid caps on spending, which actually call for cuts in spending levels for FY 2000. While acknowledging that the Federal government does indeed have an obligation to pay Elk Hills compensation under the settlement agreement with the State, the Senate Interior Appropriations Subcommittee chose to leave Elk Hills funding out of the Senate version of Interior Appropriations. As the measure went to the House-Senate Conference to work out the differences, we continued to receive signals that the House provision for $36 million in Elk Hills compensation might become a casualty of the tight budget caps as the House and Senate measures were combined.

We took a number of immediate steps. The first was to obtain a strong bipartisan show of support from all seven Californians on the House Appropriations Committee in a joint letter to House Interior Appropriations Subcommittee Chairman Ralph Regula (R-Ohio). (copy attached). The signatories included Reps. Jerry Lewis (R-Redlands), Ron Packard (R-San Clemente), Randy "Duke" Cunningham (R-Escondido), Julian Dixon (D-Los Angeles), Nancy Pelosi (D-San Francisco), Lucille Roybal-Allard (D-Los Angeles), and Sam Farr (D-Santa Cruz). In addition, Rep. Thomas made a strong plea to Chairman Regula on the House Floor, and Rep. Jerry Lewis, the third ranking Republican on the entire House Appropriations Committee, committed to talk to Chairman Regula, as did Reps. Cunningham and Farr.

We also circled back to the White House staff, with whom we had been laying a foundation over the Summer (see copies of Administration Statements of Policy attached). The Governor's office in Washington also has been quite helpful in stressing to the White House staff that Elk Hills is one of the governor's top appropriations priorities. We further followed up with Secretary of Energy Bill Richardson, who agreed to send the attached letter of support for Elk Hills to the House and Senate Conferees on Elk Hills. Senator Feinstein also weighed in with Senate Interior Appropriations Chairman Slade Gorton (R-Wash.).

As the result of all of these various efforts, the $36 million in Elk Hills funding survived and has been included in the final House-Senate Conference Agreement on the Interior Appropriations legislation. As with all of the appropriations legislation this year, there is a small wrinkle. In order to stay within the tight budget caps for this year and to minimize the need to dip into the now politically sacrosanct Social Security surplus, the Appropriations Conferees adopted the tack of "forward funding" for a significant number of spending items, including Elk Hills. Under forward funding, the appropriation is pushed off until the following fiscal year (FY 2001) – and not counted against the FY 2000 budget caps by directing that payment be made on the first day of the following fiscal year. In the case of Elk Hills, this means that the next installment of compensation would be paid to the State on October 1, 2000, rather than March 30, 2000 – a delay of only about six months.

Since the $320 million in Elk Hills compensation is being paid to the State over a seven-year period without interest, a delay of only six months does not seem appreciable. Moreover, it seems abundantly clear that the only alternative to this accounting gimmick and the six-month delay was to drop Elk Hills funding altogether from the FY 2000 appropriations legislation. Thus, while pushing the FY 2000 installment into FY 2001 could complicate somewhat next year's effort to obtain funding for the FY 2001 installment, there really was no choice if the State was to get its money.

So what happens next? After all of this, the President may veto the Interior Appropriations legislation because of concerns about various environmental issues. If the bill is vetoed, does this mean everything starts from scratch? The answer is no. Following such a veto, the Congressional appropriators would start with the bill they had passed and review the objections raised in the President's veto message. The President's objections then would become the focus of the negotiations between the Administration and the Congressional appropriators. It remains unclear at this juncture whether the Congressional GOP leaders will succeed in their effort to negotiate a vetoed Interior Appropriations measure on a stand-alone basis, or whether it would be swept into a session-end omnibus spending package as happened last year. Our efforts at that point under either scenario would be vigilance and defense, to ensure that Elk Hills funding was not dropped to offset one of the Administration's other priorities. In some sense, the fact that Elk Hills is "forward funded" into the next fiscal year gives it some insulation against such a risk.

Mandatory Social Security

Making one last effort to jump-start the debate over Social Security reform, House Ways and Means Chairman Bill Archer (R-Tex.) actually scheduled a mark-up of the Social Security reform package he drafted along with Social Security Subcommittee Chairman Clay Shaw (R-Fla.). (The Archer Shaw Social Security reform proposal was described in detail in our May Monthly Report.) The Archer-Shaw package – which still has not been reduced to legislative language – is built around the concept of private accounts with a limited range of investment options under which the participant is entitled to the greater of his or her annuitized account balance or his or her Social Security benefit as calculated under the current law formula.

However, Chairman Archer indicated that he would not go forward without the blessing of the House GOP leadership, which quickly indicated that it had enough on its hands for the remainder of the session just dealing with the appropriations measures. Accordingly, the Ways and Means mark-up of Social Security reform was quietly cancelled.

That likely should be it for the year on Social Security reform. While there remains the scant possibility that the spending negotiations between Congress and the Administration become so bogged down that a bold fresh start emerges on “big ticket” issues including Social Security, partisan acrimony and mistrust have risen to such a level as to likely preclude any such bold initiative and politically risky initiative at this late hour.

Actually, the greater threat at the moment may come from another group of retirees, the American Association of Retired Persons (AARP). It has been common knowledge for some time that AARP's leadership strongly supports mandatory coverage for all State and local workers. AARP's stance reportedly is premised on the philosophical belief in universal coverage, as well as the more practical consideration that restoration of long-term Social Security solvency might require an additional "haircut" for its membership if mandatory. Social Security for State and local workers is dropped as a funding option. However, AARP has now gone much further and is now preparing to actively attack the State and local government community on the issue of mandatory coverage.

We have learned that AARP has issued a request for proposal for a study intended to challenge the existing studies about the adverse impacts of mandatory coverage on State and local governments, plans, and employees. The study clearly is intended to undermine the strong progress made by the State and local government community this year in demonstrating these adverse impacts. The study's drive toward a pre-ordained conclusion is underscored by its tight time-line: contract awarded mid-October; progress report by early November; draft by early December; final product by the end of December. Any doubt about the outcome of the AARP study evaporated when Segal Co., which had done a study of adverse impact of mandatory coverage for the Coalition to Preserve Retirement Security, offered to expand its study for AARP and reportedly was sent away with the admonition that the existing Segal study did not have the conclusion that AARP is seeking.

The concern here is that the substantial progress made over the past year on Capitol Hill in establishing the adverse cost impact of mandatory coverage could be undermined, as the debate turns into one of dueling studies. One of the lessons we have learned over the past year is that there a significant number of Members of Congress who would be prepared to "look the other way" and let mandatory coverage happen if it proved to be a key funding component of an overall Social Security reform package. The presence of such "dueling studies" would give these Members the "out" for which they had been looking.

We have been working with the coalition of national groups of State and local government organizations to marshal various contacts, including Members of Congress, in an effort to persuade AARP that their efforts to attack the State and local government community on mandatory coverage are inappropriate and only serve to drive a wedge between different groups of retirees. Rep. Rob Portman (R-Ohio), the champion of pension security as well as the leader of the effort to protect non-covered State and local retirement systems, reportedly has expressed his concern to AARP representatives about their stance on mandatory coverage and the intent of this study.

SEC Proposed Pay-to-Play Regulations

At this juncture, it appears that the State and local government groups based in Washington are largely steering clear of commenting on the proposed "pay-to-play" regulations issued in August by the Securities and Exchange Commission. As described more fully in our August Monthly Report, these proposed SEC rules would sharply curtail campaign contributions by investment advisors to State and local government officials affiliated with public pension plans.

We understand that the National Association of State Treasurers will be filing comments in flat opposition to implementation of the proposed SEC rules. The Government Finance Officers may be filing comments suggesting changes to narrow and clarify the scope of the proposed rules. With the exception of the Council of Institutional Investors which reportedly has prepared a letter to the SEC commending the proposed rules, the other national groups of State and local retirement plans reportedly appear to be sitting this one out.

The deadline for filing on the proposed pay-to-play rules with the SEC is November 1.

Pension Provisions of Minimum Wage Legislation

The Congressional Democrats and moderate Republicans have succeeded in forcing an increase in the minimum wage onto the Congressional agenda in this session. In an effort to alleviate the cost impact on small business of such a minimum wage increase, the GOP leadership in Congress has directed that a package of tax cuts be prepared that are aimed at small business. Reportedly, this small business tax package will include the pension reform provisions from the vetoed $792 billion tax package, including the pension portability provisions for State and local plans. However, the specific details of the tax package have not yet been released.

The outlook is unclear for such a tax package linked to minimum wage legislation. Reportedly, the tax package will include a cut in the capital gains rates and will be financed out of the non-Social Security budget surplus in future years – factors which are likely to draw opposition from Congressional Democrats. In addition, the President previously has said that he will veto any tax cut legislation, including legislation linked to the minimum wage increase, that is not offset by revenue-raisers as opposed to being funded out of projected future budget surpluses.

Controversy Over Conversion of Traditional Defined Benefit Plans into Cash Balance Plans

The controversial trend among private employers of converting the traditional defined benefit retirement plan aimed at career employees into a cash balance plan tilted in favor of younger employees continues to draw attention in Congress.

Sens. Daniel Patrick Moynihan (D-N.Y.) and Jim Jeffords (R-Vt.) introduced legislation in early October that would mandate greater disclosure of the specific impact of such conversions on plan participants. The Senate version of the legislation, known as the "Pension Reduction Disclosure Act of 1999, is S. 1708. Reps. Bob Matsui (D-Sacramento) and Jerry Weller (R-Ill.) will be introducing companion legislation on the House side.

The legislation actually goes well beyond cash balance plan conversions to apply to any plan amendment that provides for "a significant reduction in the rate of future benefit accrual of 1 or more applicable individuals." the focus of the legislation is on disclosure to the adversely affected employees of the nature and impact of the proposed plan changes. For smaller employers (less than 100 employees), a basic written notice must be provided to affected employees including: a description of the plan amendment, a description of the groups of employees affected, and a description of the nature of the significant reduction in future benefit accrual. Larger employers (100 or more employees) must provide additional detail: a description of the plan's benefit formulas before and after the amendments, an explanation of the effects of the different formulas on participants, a description of circumstances in which any suspension of future benefit accruals may occur, and illustrative examples.

As the result of legislative efforts by the State and local government plan community in which we participated, the legislation is expressly made inapplicable to State and local government plans such as STRS.

House Education and the Workforce Subcommittee
Hearing on Pension Plan Investing

We understand that the House Committee on Education and the Workforce's Subcommittee on Employer-Employee Relations may be holding a hearing that could focus in part on investment practices of State and local retirement plans.

Though details remain sketchy, apparently some representatives of investment advisors to *private* pension plans are pushing for more liberal rules under the Employee Retirement Income Security Act (ERISA) regarding the manner in which stock trades and other investment transactions are carried out by broker-dealers and investment advisors acting on behalf of the plan. Thus, the focus reportedly is not on the investment practices of the plans as such, but rather the way in which investment transactions on behalf of the plan are executed, such as permitting the broker-dealer to engage in cross trades.

These investment advisors to private plans reportedly are trying to argue in support of this ERISA liberalization by pointing to the public plan sector which is not subject to ERISA, and arguing that State and local plans have not been hampered in their investment returns in the absence of these additional ERISA protections/restrictions on the carrying out of investment transactions. Reportedly, the minority staff of the Subcommittee is preparing to counter this analogy to public plans by trotting out the usual parade of horribles about past investment misdeeds in the public plan sector.

We are working with the State and local plan groups here in Washington to try to get to the bottom of this and to seek to keep public plans out of the middle of a debate that does not pertain to them.

John S. Stanton

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